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Subchapter S: What is it and How Does it Work

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SUBCHAPTER S: WHAT IS IT AND HOW DOES IT WORK

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Our economy is an economy of big business. The political, social and economic complexities of today demand that production be carried on in a grand scale. However, lest this trend toward centralization of business both on a governmental and private level be carried too far, Congress has continually by its legislation recognized the necessity of affording opportunity to the small businessman. A vivid illustration of such legislation can be found in the revisions in our tax law put into effect during 1958. Undoubtedly the most important revision was contained in the Technical Amendments Act of 1958, which became law September 2, 1958.[1] Section 64 of that created a new Subchapter S of the Internal Revenue Code entitled "Election of Certain Small Business Corporations as to Taxable Status."[2] Generally, Subchapter S permits a closely held business to operate under the corporate form without incurring any tax liability at the corporate level. Thus, instead of paying one tax at the corporate level and a second tax at the shareholder level when corporate earnings are distributed as dividends, under Subchapter S the corporate income is taxed directly to the shareholders and the corporate tax itself eliminated.[3]

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[1] Act of September 2, 1958, 72 Stat. 1606.

[2] INT. REV. CODE OF 1954, §§1371-77.

[3] In addition to Subchapter S, the Technical Amendments Act of 1958, in§57, established two new provisions of the Internal Revenue Code §§1242 and 1243. Generally, those provisions provide that loss on stock in a small business investment company operating under the Small Business Act of 1958 may be treated as an ordinary loss.

In addition to the above referred to legislation, §201 of the SMALL BUSINESS TAX REVISION ACT OF 1958, 72. Stat. 1676, created §1244 of the Internal Revenue Code. Generally, this section provides that a loss on stock in a small business corporation as defined in that Section may be treated as an ordinary loss by the shareholder.

Other tax relief provisions enacted during 1958 are reflected in the Internal Revenue Code in: §172 which provides for a three-year rather than a two-year loss carry back; §179 which permits depreciation in the first year up to $10,000; §535 which raised the permissible accumulated earnings of a corporation from $60,000 to $100,000; and §6166 which permits estates consisting primarily of small businesses to pay Federal estate taxes on an installment basis.

From a general survey of the above referred to legislation, one can conclude that Congress in passing these tax amendments and revisions was motivated by policy reasons (of aiding small businesses) rather than attempting to raise additional revenue for the government. Turning specifically to Subchapter S, various members of Congress have attempted to aid closely held businesses by its enactment since 1939. Although it has not been in effect long enough to have been interpreted in our courts through litigation, its importance has been recognized by the prolific writing to which it has been subjected. Over 60,000 corporations have taken advantage of its provisions.

PURPOSE OF SUBCHAPTER S

The purpose of Subchapter S, as stated in the Senate Finance Committee Report, is to enable small business ". . . to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences."[4] The purpose, therefore, is one of policy, to promote and aid small businesses. A business presently operating under the form of a sole proprietorship or a partnership may convert to the corporate form without being subject to a tax on the corporate level. The income earned by the corporation will be taxed directly to the shareholders in proportion to their ownership of stock. By enabling small businesses to operate under a corporate structure and avoid double income taxation, many other tax and non-tax advantages are obtained.

Subchapter S, therefore, enables sole proprietorships and partnerships to adopt the corporate form without incurring the corporate tax and is in a sense a parallel position to Section 1361 enacted in 1954 permitting proprietorships and partnerships to be taxed as corporations.

WHAT CORPORATIONS QUALIFY FOR THE BENEFITS OF SUBCHAPTER S

In enacting Subchapter S Congress has put technical limitations on the type of corporation which may elect to be taxed under that Subchapter. Section 1371 of the Internal Revenue Code states that a corporation may elect to be taxed under Subchapter S if it is ". . . a domestic corporation which is not a member of an affiliated group and which does not: (1) have more than ten shareholders, (2) have as a shareholder a person (other than an estate) who is not an individual, (3) have a non-resident alien as a shareholder, and (4) have more than one class of stock." Thus, there are six affirmative qualifications which a corporation must meet before it may elect under Subchapter S.

A. A DOMESTIC CORPORATION

First, the corporation must be a domestic corporation as defined in Section 7701(a)(3) of the Internal Revenue Code.[6] That section states that the term "corporation" includes associations, joint stock companies, and insurance companies. Generally, if the corporation is

It has been heralded by some writers as a tremendous boon to small business while others have called for its repeal. Plowden-Wardlaw, *Election of Certain Small Business Corporation as to Taxable Status*, 23 ALBANY L. REV. 245 (1959); Moore and Sorlien, *Adventures in Subchapter S and Section 1244*, 14 TAX L. REV. 453 (1959); Patty, *Qualification and Disqualification under Subchapter S*, N.Y.U. 18TH INST. ON FED. TAX 661 (1960).

[4] S. REP. No. 1983, 85th Cong. 2d Sess. 87 (1958).

[5] In addition, there are two requirements found in INT. REV. CODE OF 1954, §1372 which, if violated, will terminate the election. These two requirements refer to the amount of foreign income and personal holding income which a Subchapter S corporation may receive. They are discussed in the text at note 26 *infra*.

[6] Treas. Reg. §1.1371-1(b).

organized in the United States and is a valid corporation under the particular state law in which it was organized, it should have little difficulty meeting this first qualification. However, it should be noted that an unincorporated business which elects to be taxed as a corporation pursuant to Section 1361 of the Internal Revenue Code is not a corporation for purposes of Subchapter S and may not elect to be taxed under Subchapter S.

Recently a group of doctors formed an association which had so many of the attributes of the corporate form that they were taxed as a corporation.[7] Such an association is normally composed of professional persons and has become known as a "Kintner" type of corporation. Because they have been recognized as a corporation for income tax purposes, there appears to be no reason why such an association should not be permitted to elect to be taxed under Subchapter S.

There has also been an attempt to extend the benefits of pension plans, profit sharing plans and various other deferred compensation arrangements to professional partnerships. Originally, the legislative effort to effect this result was known as the "Keogh Bill," but it has undergone so many revisions that the latest version has little in common with the original Bill, and it is perhaps referred to more correctly as HR 10. Because the organizations to be included are basically partnerships, and because there is no change in the partnership form but rather a proposed change and extension of fringe benefits to such partnerships, in all probability an organization which qualifies for the benefits of HR 10, if it becomes law, will not qualify as a domestic corporation under Subchapter S.

B. Not a Member of an Affiliated Group

The second qualification which a corporation must meet in order to elect under Subchapter S is that it not be a member of an affiliated group as defined in Section 1504 of the Internal Revenue Code.[8] This means that it cannot be eligible to file consolidated returns with another corporation. Generally, an 80% control test is applied. That is, if a small business corporation wishes to elect under Subchapter S, it may own 79% of a subsidiary but it may not own 80% of a subsidiary. This suggests that in cases where this qualification cannot be met, there may be a redistribution of stock within the family group so that the 80% qualification can be met.[9] As Subchapter S was originally

[7] See: Galt v. Commissioner, 216 F. 2d 41 (7th Cir. 1954); United States v. Kintner, 216 F. 2d 418 (9th Cir. 1954); proposed Treas. Reg. §301.7701-2. See also Maier and Wild, *Taxation of Professional Firms as Corporations,* 44 Marq. L. Rev. 127 (1960).

[8] Int. Rev. Code of 1954, §1504. A Subchapter S corporation may not be a member of an affiliated group either at the time of election or at any time during which the election is in effect.

[9] In addition, where the 80% test cannot be met, other sections of the Code

enacted, a corporation, after electing under Subchapter S, could become a member of an affiliated group. This drafting error was corrected by amendment so that under the present law a corporation may not be a member of an affiliated group and still elect under Subchapter S or remain under Subchapter S.[10]

C. Not More Than Ten Shareholders

The third qualification for election is that there may not be more than ten shareholders. In this regard it should be noted that the definition of a Subchapter S corporation should be termed "closely held" rather than "small" because there is no limit to the financial size of the company nor to the number of employees it may have. The only limit to the size of a Subchapter S corporation relates to the number of stockholders of the corporation. In counting stockholders, nominees, agents, custodians and guardians are not included, but rather the beneficial owners of the particular stock are counted.[11] Questions may arise concerning the shareholders who may be legal life tenants, remaindermen, or assignees for creditors, because they have only partial interests and the Code and Regulations do not specifically state whether a temporary present interest, such as a legal life tenant, or a contingent future interest, such as a remainderman, should be counted in determining the ten shareholders.[12] It should be noted that in many sections of the Code, particularly those dealing with closely held corporations, family attribution rules are applied whereby one member of the family is considered the owner of shares owned by any other member of the family.[13] There are no family attribution rules which apply to Subchapter S for purposes of the ten (10) shareholder rule.[14]

As the Subchapter was first enacted, a husband and wife were each counted as a shareholder even though they were co-owners of the stock. However, an amendment has been passed whereby if a husband and wife are joint tenants, tenants in common, tenants by the entirety or owners of stock in a community property state, they are considered as one shareholder for purposes of the ten shareholder rule; but both

should be explored to determine their usefulness in dividing stockownership in each individual case. Thus, consideration should be given to: §302, redemption of stock; §332, liquidation of a subsidiary; §346, partial liquidations; and §368, tax free reorganizations, among others.

[10] Int. Rev. Code of 1954, §1504, was amended in 1959 by eliminating §1508(b)-(8). Thus, a Subchapter S corporation is no longer excluded from being an "includible corporation" under that section.

[11] Treas. Reg. §1.1371(d)(1).

[12] See Note, *Optional Taxation of Closely Held Corporations under Technical Amendments Act of 1958*, 72 Harv. L. Rev. 710, 712 (1959).

[13] Int. Rev. Code of 1954, §§267, 318 and 544 contain three major sets of attribution rules. For a discussion of attribution rules contained in the Code see: Ringel, Surrey, and Warren, *Attribution of Stock Ownership in the Internal Revenue Code*, 72 Harv. L. Rev. 209 (1958).

[14] See Rev. Rul. 59-187, 1959-1 Cum. Bull. 224.

must consent to the election.[15] Where the husband and wife own stock separately, they are still treated as individual shareholders for purposes of the ten shareholder rule.

Originally it was anticipated that various forms of ownership would create problems as to the number of shareholders. However, the final regulations state that where shares are owned in joint tenancy, in tenancy by entirety, in tenancy in common, or as community property, then, except in the case of husband and wife being the owners, each of the owners is counted.[16]

D. ONLY INDIVIDUALS AND ESTATES MAY BE SHAREHOLDERS

The fourth qualification for election under Subchapter S is that only individuals and estates may be shareholders. Thus, trusts, partnerships, and corporations may not be shareholders, because multiplicity of interests was not intended to be protected under this subchapter.[17] In other words, one cannot circumvent the limit of ten shareholders by establishing a trust with fifteen beneficiaries and having the trustee as owner of the stock.[18] In addition, a voting trust may not be a shareholder.[19]

Because of this limitation which prevents a trust from being a shareholder, problems may arise on the death of a shareholder, particularly in instances where a trust has been created under the deceased's will. The stock may not be placed in the trust established under the will if the corporation is to remain a Subchapter S corporation.

Note should be made that gifts to minors may also create problems, because such gifts are normally made to a trust established for the benefit of the minor. However, stock transferred to a guardian for a minor is permissible and does not violate this qualification even though a form of fiduciary relationship has been created.[20] If a stock is transferred to a legal custodian for a minor, such transfer would not prevent qualification under Subchapter S.[21] In such a case there would appear to be no danger of circumventing the ten shareholder rule by the creation of multiple interests as there is in the case of trusts, partnerships, corporations or voting trusts.

Another troublesome area is that of joint ventures. Generally, joint

[15] INT. REV. CODE OF 1954, §1371(c); Treas. Reg. §1.1371-1(d)(2).

[16] Treas. Reg. §1.1371-1(d)(1).

[17] It should be noted that there is an inconsistency in the Code and Regulations in regard to the owner of trust assets in a Clifford trust. The settlor is considered the owner under certain circumstances pursuant to Sections 671 through 678. Yet, for purposes of Subchapter S, the trust, itself, is treated as the owner. Treas. Reg. §1.1371-1(d).

[18] For the same reason, a partnership may not be a shareholder because if it could, the shareholder could form a partnership whenever there was difficulty in meeting the ten shareholder rule. See also Rev. Rul. 59-235, 1959-2 CUM. BULL. 192.

[19] Treas. Reg. §1.1371-1(d)(1).

[20] Treas. Reg. §1.1371-1(d)(1), T.I.R. No. 113 (1958).

ventures are classified as partnerships for tax purposes[22] and, thus, may not be stockholders under Subchapter S.

E. A Non-Resident Alien May Not be a Shareholder

The fifth qualification under Subchapter S is that a non-resident alien cannot be a shareholder. This qualification is clear and should present no particular problems except where alien shareholders spend a considerable amount of time outside of the country.

F. Only One Class of Stock

The sixth specific qualification for election under Subchapter S is that there may be only one class of stock. At the outset it should be noted that the limitation refers to issued and outstanding stock and not to authorized stock. Thus, the corporation may have more than one class of stock authorized so long as there is only one class of stock issued and outstanding.

Voting and non-voting stock consist of two separate classes for purposes of Subchapter S. The only distinction that may exist between issued and outstanding classes of stock of a Subchapter S corporation relates to the election of directors. That is, each class may elect its own directors, but the number elected must be in proportion to the number of shares held by that class of shareholders.[23]

Caution should be exercised in electing under Subchapter S if the corporation has been thinly capitalized. In such instances the Treasury Department may take the position that the debt which far exceeds the capital consists of a separate class of stock, and the existence of such class of stock would terminate the election under Subchapter S.[24]

Under the same reasoning care must be taken as to what bonds are issued so that they do not resemble another class of stock. In other words, one cannot accomplish under Subchapter S with bonds what could be accomplished with the use of preferred stock.[25]

G. Additional Requirements for Qualification

The above six requirements for qualification under Subchapter S are specifically listed as conditions precedent to the election. In addition

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[21] Wis. Stats. §§319.61 *et seq.* (1959).

[22] See Int. Rev. Code of 1954, §§7701(a)(2) wherein joint venturers are considered to be partners.

[23] Treas. Reg. §1.1371-1(g).

[24] For a discussion of problems relating to thin capitalization generally, see: Caplin, *The Caloric Count of a Thin Corporation,* N.Y.U. 17th Inst. on Fed. Tax 771 (1959), 43 Marq. L. Rev. 31 (1959).

[25] The Small Business Investment Act of 1958 authorizes certain investment companies to issue bonds which are convertible to stock. This type of bond may constitute another class of stock for purposes of Subchapter S with the net result that individuals may have to choose between electing under Subchapter S and coming under the provisions of the Small Business Investment Act. Although it appears that the Treasury Department may force such an election, it was clearly not the intent of Congress to exclude the benefits of one of these acts to a corporation merely because they have chosen to obtain the benefits of the other act.

thereto there are two additional requirements for qualification in the sense that if these requirements are not met, the qualification will be terminated.[26] Thus, in effect, they are requirements, but are stated in the nature of conditions subsequent which will terminate the election, rather than conditions precedent which must be present before the election is made. They are, therefore, treated as requirements seven and eight for the election under Subchapter S.

1. *Income From Foreign Sources*

The seventh requirement is that the election shall terminate if for any taxable year the corporation derives more than 80% of its gross receipts from sources outside the United States.[27] Thus, Subchapter S is not available to those corporations which operate solely without the United States.

2. *Personal Holding Company Income*

The eighth and final requirement is that the election will terminate for any year in which the corporation has gross receipts more than 20% of which are derived from royalties, rents, dividends, interest, annuities and sales or exchanges of stock or securities.[28] Basically, this is an attempt to prevent personal holding companies and investment companies from coming under the benefits of Subchapter S.

H. CHECKLIST FOR QUALIFICATION

Considering all of the above qualifications, therefore, if a corporation seeks to elect under Subchapter S it must be able to answer "YES" to each of the following questions which are presented in the form of a checklist:

1. Is the corporation a domestic rather than a foreign corporation.
2. Is the corporation prohibited from filing consolidated returns with any other corporation.
3. Are there ten or less shareholders.
4. Are all shareholders individuals or estates.
5. Are all shareholders non-aliens or residents.
6. Is there only one class of stock issued and outstanding.
7. Are less than 20% of the gross receipts derived from the following sources: royalties, rents, dividends, interest, annuities, and gains from the sale or exchange of stock or securities.

PROCEDURE FOR ELECTING

Turning to the actual election which must be made, Section 1372 of the Internal Revenue Code provides that if the election is made prior to or at the beginning of the tax year all shareholders must consent on the first day of such year. If the election is made after such first day, all shareholders must consent on the day of election. The

[26] INT. REV. CODE OF 1954, §1372(e) (4) and (5).
[27] INT. REV. CODE OF 1954, §1372(e) (4).
[28] INT. REV. CODE OF 1954, §1372(e) (5).

election will eliminate the corporate tax for the current year and succeeding years until the election is terminated. The election must be made during the first month of the year or the month immediately preceding it on Form 2553.

Basically therefore, there are two requirements for election. First, Form 2553 must be executed by the officers of the corporation authorized to act. The Form generally contains the following information: (1) the name and address of the corporation; (2) the date the election is submitted; (3) the date and place of incorporation; (4) the first taxable year for which the election is made; (5) the number of shares of stock issued and outstanding; (6) the predecessor organization or corporation, if any; (7) the principal business activity of the corporation; and (8) the name and address of each shareholder, the number of shares owned by each and the Internal Revenue District where each shareholder files his return.

The second basic requirement for election is that all shareholders consent to the election. The consent is to be attached to the election and must contain the name and address of the corporation and each shareholder. It must also state the number of shares owned by each shareholder and the date or dates on which each acquired his stock.

Because of the time limitation of filing an election, that is, in the first month of the corporate tax year or the month immediately preceding, the date on which a corporation is considered to have commenced its existence is of vital importance. The regulations provide that a corporation comes into existence on the date that ". . . a new corporation has shareholders or acquired assets or begins doing business, whichever is the first to occur."[29] Under general corporate law, a corporation comes into existence on the day that its Charter or Articles are recorded in the office of the Register of Deeds in the County of its principal office.[30] The regulations seems to be more lenient in that some later day may be accepted as the date of organization and the date from which the thirty day time limitation for filing an election under Subchapter S commences. For practical purposes, however, it is suggested that the election be made within thirty days of recording the Articles of Incorporation in the office of the Register of Deeds.

Once an election has been made it may not be voluntarily revoked for that year.[31] However, if it is terminated involuntarily, the termination will be retroactive to the beginning of the tax year.[32] Because of the ease with which a termination may be affected, the fact that an election may not be withdrawn during the year becomes meaningless.

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[29] Treas. Reg. §1.1372-2(b)(1).
[30] See, for example, WIS. STAT. §180.46 (1959).
[31] INT. REV. CODE OF 1954, §1372(e)(2).
[32] Treas. Reg. §1.1372-4(c).

There are certain special problems relating to an election under Subchapter S. If minors are involved, the consent must be made by the minor or his legal or natural guardian.[33] If the consent is made by the minor, problems may arise under State law if such law provides that a minor is not capable of executing a contract.[34]

If a shareholder should die and his estate becomes the new shareholder, the question arises as to whether the estate must file an election as a new shareholder. Because of the ambiguity in this area it is suggested that the estate file an approval of an election signed by the executor or administrator.[35] The regulations provide that an estate which is a new shareholder must file a consent by the executor or administrator within thirty days of his appointment, but ". . . in no event shall such period begin later than thirty days following the close of the corporation's taxable year in which the estate became a shareholder."[36] Therefore, if death occurred on December 28, 1959, the election must be made by March 1, 1960. This may not provide enough time for the appointment of an executor or administrator, particularly when dealing with substantial estates.

Tax Effect on Stockholders and the Corporation During Election Years

Under Subchapter S the shareholders report the taxable gain or net operating loss of the corporate operation directly on their individual tax returns in proportion to their stock ownership. The corporation itself must file an information return on Form 1120-S, but it is not subject to tax.[37]

A. Who Pays the Tax

Under Section 1372(b) an electing corporation is exempt from tax. Section 1373(a) provides that the shareholders must include in their taxable income the income earned by the corporation.

B. The Amount to be Taxed

The shareholders are taxed on amount of taxable income of the corporation which was distributed as a dividend and which would have been a dividend if all of the taxable income were distributed.[38] In other words, the amount of taxable income of the corporation is first computed. Then that income is taxed to the shareholders in proportion

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[33] Treas. Reg. §1.1372-3(a).

[34] A conflict of laws problem may arise, in that federal law may supersede state law for tax purposes in determining whether a minor is legally capable of filing a consent under Subchapter S.

[35] See discussion at Note 70 *infra.*

[36] Treas. Reg. §1.1372-3(b).

[37] Int. Rev. Code of 1954, §6037. Although form 1120-S requires income to be computed in a manner similar to non-Subchapter S corporations, Schedule K thereof resembles a partnership return in that it provides for a disclosure of each shareholder's portion of income from the corporation.

[38] Int. Rev. Code of 1954, §1373(b).

to their stock holdings as if it were a dividend. The relationship to dividends means that the amount taxed to the shareholders is limited to the amount of earnings and profits in the corporation, because dividends may only be declared from earnings and profits.[39] It should be noted that there are certain qualifications on the computation of taxable income of a Subchapter S corporation. Thus, taxable income under Subchapter S must be computed without regard to: any net operating loss deduction, the 85% deduction for dividends received from domestic and certain foreign corporations, the deduction for partially tax-exempt interest on certain U.S. obligations, and the deduction for dividends received on preferred stock of public utilities.[40]

C. When is the Income Taxed

The income of the corporation which is distributed during the tax year becomes taxable income to the shareholders on the date distributed. Any taxable income of the corporation which is not distributed during the corporate year is taxed on the last day of the corporate year.[41] This amount is technically referred to as "undistributed taxable income." Thus, whatever income has not been distributed during the year is fictitiously distributed on the last day of the tax year as if it were a dividend. Here again the relationship to earnings and profits comes into the picture. Generally, the income which is left in the corporation should be kept in a special account, and may later be withdrawn by the shareholder who paid the tax thereon.

D. Cash Distributions

The tax treatment of distributions of *CASH* by a Subchapter S corporation is as follows:

1st. Cash distributions are treated as dividends to the recipients thereof to the extent of current earnings and profits. Current earnings and profits are then reduced by the amount of cash distributed.[42]

2nd. If the cash distributed exceeds the current earnings and profits, then such excess cash distribution is treated as being made from previously taxed income, if any, of the corporation and is received on a tax free basis by the shareholders to the extent of such previously taxed income.[43] To the extent that such cash distributions are received on a tax free basis, the shareholder's basis in his stock is reduced.[44]

3rd. If the cash distributions also exceed the amount of previously taxed income retained by the corporation, or if the corporation

39 Int. Rev. Code of 1954, §316.
40 Int. Rev. Code of 1954, §1373(c).
41 Int. Rev. Code of 1954, §1373(b). Since the shareholder is undoubtedly on a cash basis, he reports the income either when actually received or when constructively received on the last day of the corporate tax year.
42 Treas. Reg. §1.1373-1(d).
43 Treas. Reg. §1.1375-4(b).
44 Treas. Reg. §1.1375-4(a).

has retained no previously taxed income, then such excess cash distributions will be considered as having been made from accumulated earnings and profits and will accordingly be taxed as a dividend. To the extent of such taxable dividends, the accumulated corporate earnings and profits will be reduced. It should be noted that the corporation, with consent of all its shareholders, may elect to reverse the above order and consider cash distributions to be made out of accumulated earnings and profits prior to previously taxed income.[45] Such election should be made if the shareholders have substantial losses from other business ventures against which the increased dividend may be offset.

4th. Finally, if the cash distributions exceed current earnings and profits, the amount of previously taxed income which has been retained, and accumulated earnings and profits, such excess will first serve to reduce the basis of the shareholders' stock, and, to the extent that it exceeds such basis, will be treated as money received on a sale or exchange of a capital asset.[46]

The above order of distribution can be illustrated by the following example:

> Assume that at the beginning of 1961 a Subchapter S corporation has $10,000 of accumulated earnings and profits and $6,000 of income which was previously taxed to the shareholders and retained by the corporation. During 1961 the corporation had taxable income and current earnings and profits of $8,000. The corporation also made cash distributions of $30,000 during 1961.

Tax result of $30,000 cash distribution:

Dividend to extent of current earnings and profits	$ 8,000
Tax free distribution of previously taxed income	6,000
Dividend to extent of accumulated earnings and profits	10,000
Amount by which basis of shareholders' stock is reduced (return of capital)	6,000
	$30,000

A general rule is that all of the taxable income of a Subchapter S corporation should be distributed each year. Perhaps this rule can best be set for by illustrations.

Example 1:

The right to withdraw income earned by the corporation which has previously been taxed to a shareholder is personal to the shareholders who paid the tax thereon.[47] Thus, a sale or gift to a third party or a termination of the election (even though followed by a subsequent re-election) will prevent the

[45] Treas. Reg. §1.1375-4(c).
[46] INT. REV. CODE OF 1954, §301(c).
[47] INT. REV. CODE OF 1954, §1375(d) and Treas. Reg. §1.1375-4(e).

withdrawal of any previously taxed income by the new shareholder from the corporation on a tax-free basis during any year in which the corporation has earnings and profits.

For example:

Assume in 1959 a father is taxed on $10,000 of corporate income and leaves that amount in the corporation. In 1960, he transfers his stock to his children. If and when the children attempt to withdraw the previously taxed $10,000 from the corporation, they must include it as a taxable dividend on their own income tax returns to the extent that the corporation has earnings and profits, and, in effect, pay a second tax on the same amount of money. It should be noted that if the corporation had no earnings and profits at the time the $10,000 was withdrawn, the withdrawal would be treated as a tax free distribution of capital and would only serve to reduce the shareholder's basis of stock (or be taxed as a sale or exchange of a capital asset to the extent that the $10,000 distribution exceeded such basis). Since under Subchapter S earnings and profits are reduced by the amount of taxable income, whether distributed or not, the problem only become accute where there are accumulated earnings and profits or where current earnings and profits exceed current taxable income.

Example 2:

If income is taxed to a shareholder and left in a corporation, a double tax may result through the operation of a subsequent net operating loss. Under Subchapter S, a net operating loss will reduce the amount of previously taxed income. For example:

If in: (a) 1959 there is $25,000 of taxed income left in the corporation which has accumulated earnings and profit in excess of $15,000;
(b) 1960 there is a net operating loss of $15,000;
(c) 1961 there is no income but merely a distribution of the previously taxed income of $25,000;

Then (a) in 1959—tax on $25,000;
(b) in 1960—loss on $15,000;
(c) in 1961—tax on $15,000;

Therefore, if the income of $25,000 in 1959 is left in the corporation there is a tax paid on a total amount of $40,000 whereas if all taxable income had been distributed, there would only be a tax on $25,000 of income.

The above examples illustrate that taxable income in most cases should be distributed each year by an electing Subchapter S corporation,[48] particularly in those instances where the corporation has either

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[48] This means that the corporation will have to estimate its taxable income prior to the close of its tax year.

accumulated earnings and profits or has current earnings and profits in excess of current taxable income. Inevitably, however, the corporation will need cash for expansion. The problem then becomes how to get the cash back into the corporation without "locking it in." Perhaps the best solution would be to loan the income back to the corporation. Such loans should be evidenced by a promissory note.[49] This procedure of loaning money back to the corporation may eventually create a problem of thin capitalization; in which event the stockholders will have to determine whether their situation dictates that they leave the money in the corporation and face the problems illustrated in the above examples or take the money from the corporation and return it as a capital contribution, thus "locking it" back in the corporation.

E. Property Distribution

Property distributions are treated differently from cash distributions both in regard to the taxable income of the corporation and to earnings and profits. Distributions in kind do not serve to reduce taxable income,[50] and, thus, to the extent that there may be accumulated earnings and profits, may unnecessarily increase taxable income. For example:

> Assume that a Subchapter S corporation has at the beginning of 1961:
> Accumulated earnings and profits ....$ 40,000
> Taxable income and current earnings and profits during 1961 100,000
> During 1961 a dividend in kind of $25,000 is declared.
> Result:
> There is a tax on ....$ 25,000 (property distribution)
> and a tax on .... 100,000 (constructive dividend)
>
> Total tax on $125,000

Thus, because there were earnings and profits in excess of the property distribution and the taxable income, and because a property distribution (unlike a cash distribution) will not reduce taxable income, the shareholders must pay a tax on $125,000 even though the corporation only earned $100,000 during the year and only distributed property of a value of $25,000.

Property distributions differ from cash distributions in regard to earnings and profits in that earnings and profits are applied to cash distributions before they are applied to property distributions. The regulations provide that earning and profits are to be applied with the following priority:[51]

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[49] See text at Note 60 *infra*.

[50] The definition of "undistributed taxable income" may be found at Int. Rev. Code of 1954, §1373(c). Such income is reduced by distributions of "money" but not by distributions of property.

[51] Treas. Reg. §1.1373-1 (e).

1st. Current earnings and profits are applied to cash distributions;
2nd. The excess, if any, of current earnings and profits over cash distributions is applied ratably to property distributions and undistributed taxable income.
3rd. Any accumulated earnings and profits are then applied to any untaxed portions of property distributions and to any untaxed portion of undistributed taxable income;
4th. Any remaining earnings and profits are then available to be allocated to distributions in exchange for stock of the corporation.

Perhaps the following examples will illustrate the above order of priority:

Example 1:

Assume a Subchapter S Corporation has at the beginning of 1961 the following:

Accumulated earnings and profits	$ 40,000
Current taxable income and current earnings and profits during 1961	100,000

During 1961 the corporation distributed property with a value of $25,000.

Result:

From current earnings and profits	
Tax on property dividend of:	$ 20,000
Tax on constructive dividend of:	80,000
From accumulated earnings and profits	
Tax on property dividend of:	5,000
Tax on constructive dividend of:	20,000
Total amount taxable to shareholders:	$125,000

Example 2:

Assume a Subchapter S corporation has the following at the beginning of 1961:

Accumulated earnings and profits	$ 10,000
Previously taxed income	2,000

During 1961 the corporation has the following activity:

Current earnings and profits and taxable income	18,000
Cash distributions	15,000
Property distributions	9,000

Result:

Cash dividend from current earnings and profits	$ 15,000
Allocation of remaining current earnings and profits of $3,000:	
Undistributed taxable income of $3,000	750
Property distribution of $9,000	2,250
Accumulated earnings and profits allocated to:	
Remaining undistributed taxable income	2,250
Remaining property distribution	6,750
Total taxed to shareholders	$ 27,000

Thus, because of the existence of accumulated earnings and profits, the next effect is to tax the value of any property distribution as well as the taxable income of the corporation to the shareholders.[52]

Property distributions also differ from cash distributions in that a property distribution may never be made from previously taxed income which has been retained by the corporation.[53]

Thus, because of the reasons as illustrated above, a general rule may be drawn that a Subchapter S corporation should avoid property distributions particularly if there are accumulated earnings and profits.

F. DISTRIBUTIONS IN EXCHANGE FOR STOCK

In the event a shareholder of a Subchapter S corporation receives a distribution from the corporation in exchange for his stock in said corporation, the normal rules relating to stock redemptions should apply.[54] Because of the limited number of shareholders of a Subchapter S corporation, particular care should be taken not to bring the family attribution rules into play so as to cause the redemption to be taxed as a dividend where there are accumulated earnings and profits.

G. CAPITAL GAINS, NET OPERATING LOSS AND ADJUSTMENT TO BASIS

The taxation of a Subchapter S shareholder is similar to the taxation of a partner in that the net gain or loss from the business operation is taxed directly to the shareholder. However, under a Subchapter S situation, special attention must be given to the treatment of capital gains, to the treatment of a net operating loss and to adjustments which must be made to the basis of a shareholder's stock.

1. *Capital Gains and Losses*

Should the net operation of the corporation result in a gain, each shareholder will be entitled to pro rata share of whatever capital gains the corporation may have had.[55] However, the total capital gains may not exceed the net gains of the corporation. Thus, in effect long term capital gains must be offset against ordinary losses of the corporation, and only the net amount may pass through to the shareholders as capital gains. This would suggest that capital gains be taken in those years where few or no ordinary losses are anticipated. It should also be noted that a net capital loss in the corporation will neither reduce the undistributed taxable income of the corporation, nor may it be taken into account by the shareholders.[56] Such net capital loss will, however, serve to reduce accumulated earnings and profits.

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[52] See also Treas. Reg. §1.1373-1(g), examples 3 and 4.
[53] Treas. Reg. §1.1375-4(g), example 4.
[54] INT. REV. CODE OF 1954, §302.
[55] INT. REV. CODE OF 1954, §1375(a).
[56] Under Subchapter S ordinary gains are taxed to the shareholders. INT. REV. CODE OF 1954, §1373. Capital gains are treated separately under INT. REV. CODE OF 1954, §1375, which states that capital losses may be used to offset capital

2. *Net Operating Loss*

If the corporation has a net operating loss, the shareholders may take this loss on their individual returns as a net operating loss.[57] This means that the shareholders will be entitled to a net operating loss carry back and carry forward. Furthermore, the net operating loss allocable to each shareholder is determined according to the number of days during the corporate tax year that each shareholder owned his stock.[58] This is in contrast to the rule whereby any undistributed income is taxed to the shareholders of record as of the last day of the corporate tax year.

There is a distinct limit on the amount of net operating loss which any shareholder may take on his individual tax return. Thus, the net operating loss allocable is limited to the sum of the adjusted basis of such shareholder's stock plus the adjusted basis of any indebtedness of the corporation to the shareholder.[59] In other words, the net operating loss first serves to reduce the basis of a shareholder's stock and any excess is applied against the basis of any corporate indebtedness owing to the shareholder. In the event the net operating loss exceeds the shareholder's basis in his stock and in such indebtedness, the shareholder should consider either contributing additional amounts to the corporation or loaning additional funds to the corporation in order to take full advantage of the ordinary loss. So long as the loan does not exceed the capital of the corporation to such extent as to create problems of thin capitalization with the possible result of having the debt treated as a second class of stock (thus terminating the election), it would appear to be more satisfactory to take advantage of a loss by the loan route rather than by an additional contribution to capital or by purchase of additional stock. The latter course of action would lock the funds in the corporation. There is a possibility that the loan arrangement may be termed a sham and disallowed. Also, the shareholder will recognize gain on the repayment of the loan because the basis of the loaned amount has been reduced by operation of the net operating loss. However, if the loan is outstanding more than six (6) months and if a promissory note is used as evidence of the loan, the gain may be entitled to capital gain treatment.[60].

3. *Adjustment to Basis of Stock*

The basis of a shareholder's stock is increased by the amount of

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gains. The only losses which may otherwise be taken by the shareholders on their individual returns are net operating losses under INT. REV. CODE OF 1954, §1373. There is no provision for carrying capital losses through to the individual's return.

[57] INT. REV. CODE OF 1954, §1374.

[58] INT. REV. CODE OF 1954, §1374(c).

[59] INT. REV. CODE OF 1954, §1374(c)(2).

[60] The evidence of indebtedness should be such as will be recognized under INT. REV. CODE OF 1954, §1232 as qualifying for capital gain treatment.

income which is left in the corporation and which is taxed to the shareholder at the end of the corporate tax year that ends within or with the shareholder's tax year.[61] Thus, if a sale of stock occurs during the year, it appears that there may be two taxes. The first tax would be a capital gains tax to the seller while the second would be an ordinary gain, measured by undistributed taxable income, taxed to the buyer at the end of the tax year. This indicates that the buyer should discount the price to the extent of undistributed taxable income, or that perhaps the corporation should declare a cash dividend of all current earnings immediately prior to the sale.

The basis of a shareholder's stock will be decreased, but not below zero, by an amount equal to his portion of the net operating loss. Any excess of the net operating loss over such basis would be applied against the indebtedness of a corporation to a shareholder to reduce the basis of such indebtedness.[62] It should be noted that when such indebtedness is reduced a later accumulation of undistributed taxable income in subsequent years will only serve to increase the basis of stock and will not serve to increase the basis of indebtedness which was reduced in prior years.

H. Example of the Application and Use of Subchapter S

Perhaps some of the mechanics of taxation under Subchapter S can best be understood by examining a hypothetical case and reviewing its operation.

Assume a partnership in which the father and son each have a 50% interest. They wish to accomplish the following objectives: (1) obtain some control of the individual's income by placing income in one tax year or the next tax year; (2) establish an employee incentive program; (3) provide for continued payments to the widow in the event one of them dies; and (4) provide for a buy-out agreement so that on the death of one of them the survivor will have control of the entire business and will not be hampered by disinterested or possibly adverse third parties.

Under these circumstances an election could be made under Subchapter S with the following results: (1) by selecting an appropriate fiscal year it is possible to defer the income of the initial year to the following year.[63] For example, assume the corporation adopts a Jan-

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[61] Int. Rev. Code of 1954, §1376(a).

[62] Int. Rev. Code of 1954, §1376(b).

[63] Congress may change the law and require that a Subchapter S corporation adopt a tax year identical to that of its major shareholders, as a partnership must do. However, until such change is made, the new Subchapter S corporation may select its own fiscal year. Furthermore, if a Subchapter S corporation had to adopt a tax year identical to that of its major shareholders, the door would be open to many present corporations to change tax years and thus control and possibly reduce income for at least one tax year by electing under Subchapter S. There could be a "short" taxable year.

uary 31st fiscal year. If no dividends were declared during 1960, the first year of operation, the income would be taxed to the shareholders as of January 31, 1961. This, in effect, means that the income would be deferred from the shareholder's personal income tax for one year, and actually reported April 15, 1962. In addition, by selecting a fiscal year and declaring dividends in one calendar year or the following calendar year, a certain amount of control in determining which year the corporate receipts become taxable to the shareholder may be obtained. (2) A profit sharing plan or a pension plan could be established which would provide an incentive program for the employees. Because the father and son are principal officers, receive the highest compensation and have the greatest number of years of service, a substantial amount of the profit sharing fund could inure to their benefit. (It should be noted that the father and son will only have prior years of service for purposes of a pension or profit sharing plan subsequent to the establishment of the corporate entity, because sole proprietors and partners are not employees and consequently are not eligible for qualified welfare benefits.) In addition, if the plan were integrated with social security, those employees in the higher income brackets would receive a greater proportion of the benefits of the pension or profit sharing plan. (3) A third result which could be obtained by electing under Subchapter S relates to the buy-out agreement and the continued payments to the widow of the first stockholder to die. The agreement between the two shareholders could provide that the surviving stockholder would purchase 20% of the deceased's stock each year for the five years following death. In this way, the following results could be achieved: (a) assuming the corporation distributed its taxable income annually, the widow would receive income for five years following the death of her husband in gradually diminishing amounts in proportion to her stock ownership; (b) on each sale the widow or the estate would be entitled to capital gains treatment (there should be little or no recognized gain because the stock was entitled to a stepped up basis at time of the shareholder's death); (c) the problems of family attributions in stock redemption under sections 302 and 318 and the ordinary income therefrom would be avoided by use of the cross purchase agreement rather than the entity agreement;[64] (d) the agreement would be workable regardless of whether the father or son died first; and (e) by purchasing the stock in installments and by providing that the payments may be made by promissory notes payable over a number of years, no undue burden of providing a lump sum payment at any one time would be placed upon the survivor. (4) A fourth factor to be considered in the above example of electing under Subchapter S relates

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[64] See Laikin, *Stock and Redemptions: Sections 302 and 318*, N.Y.U. 14TH INST. ON FED. TAX 671 (1956).

to the wills of the shareholders. Their wills should contain proper instructions to the executor either to elect or not to elect under Subchapter S.

INSURANCE AND SUBCHAPTER S

A. THE FUNDING OF BUY-OUT AGREEMENTS

The requirements for qualification under Subchapter S are technical and easily violated; and the results of termination of the election by violating one of those requirements can be so disastrous that protection must be provided against involuntary termination of the election. One of the essential and basic protections is the restriction against the transfer of stock, either to a trust or to such number of outsiders as will result in the corporation having more than ten shareholders. This, in turn, necessitates a buy-out agreement of some type whereby the surviving shareholders or the corporation, itself, either must purchase or have a first right to purchase the stock of a shareholder if he wishes to sell during his lifetime, together with provisions for purchase of the stock from his estate at his death. Because most businesses which elect under Subchapter S will be small businesses and financially incapable of funding such agreements from accumulated earnings, insurance may be a necessity.

B. THE USE OF INSURANCE AND FRINGE BENEFITS

In addition to the use of insurance in buy-out agreements, all of the various corporate arrangements whereby insurance can be employed become available to the Subchapter S corporation, whereas they were not available when previously operating as a partnership or a sole proprietorship. Thus, deductible group insurance plans, accident and health plans, pension plans funded with insurance, and other fringe benefits now become available to the shareholders.

TERMINATION OF THE ELECTION

Having examined the requirements and qualifications for election, we turn now to the various methods of terminating the election under Subchapter S.

A. VOLUNTARY REVOCATION

After the election under Subchapter S has been in effect for one year, it may be revoked by a statement executed by all of the shareholders within the first month of the corporation's tax year.[65] The signed revocation is to be filed in the office of the district director where the corporation normally files its tax returns.[66] If the election is filed subsequent to the first month of the corporation's tax year, then it does not become effective until the following tax year.[67] Because

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[65] INT. REV. CODE OF 1954, §1372(e)(2).
[66] Treas. Reg. §1.1372-4(b)(2).
[67] Treas. Reg. §1.1372-4(c).

an involuntary termination is easily effected, it is doubtful whether a voluntary revocation, executed by all of the shareholders within the first month of the corporate tax year, will ever be used.

B. INVOLUNTARY TERMINATION

In the event a voluntary revocation is not filed, the election under Subchapter S may terminate involuntarily or accidently under any one of the following eight conditions.

First, the election will terminate if a new shareholder does not consent to the election within thirty (30) days after becoming a shareholder.[68] A transfer of shares to a new shareholder becomes effective when title passes. The Uniform Stock Transfer Act defines such time as the time of delivery as distinguished from the time of transfer on the books of the company.[69] Therefore, a new shareholder must consent within thirty (30) days of the time of delivery of the shares. There is some question as to whether an estate is a new shareholder, but it would be advisable for an estate to file an approval and reaffirmation of the election.[70]

Subchapter S provides that an election under that subchapter will terminate if the corporation ceases to be a small business corporation as defined therein.[71] Therefore, the remaining seven circumstances under which an election will terminate, relate directly to the requirements for initial qualification.

The second circumstance under which an election will terminate is if the corporation becomes a member of an affiliated group.[72]

Third, the election will terminate if the corporation has more than ten shareholders. Thus, a transfer of stock during lifetime or a disposition of stock in a shareholder's estate to additional persons may accidently terminate the election and bring on disastrous tax results.

Fourth, the election will terminate if the corporation has a shareholder other than an individual or an estate. Transfers of stock to an intervivos or testamentary trust will terminate the election. In this regard Subchapter S lacks flexibility and restricts the transferability of

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68 INT. REV. CODE OF 1954, §1372(e)(1); Treas. Reg. §1.1372-3(b).

69 UNIFORM STOCK TRANSFER ACT, §§1 and 5; WIS. STATS. §§183.01 and 183.05 (1959).

70 Treas. Reg. §1.1372-3(b) deals with the consent which must be submitted by new shareholders and provides in part: "If the new shareholder is an estate, the 30-day period shall not begin until the executor or administrator has qualified under local law to perform his duties, but in no event shall such period begin later than 30 days following the close of the corporation's taxable year in which the estate became a shareholder." It is uncertain whether an estate is a "new shareholder" when it merely succeeds to the interest of the deceased as distinguished from those cases where the estate purchases stock of a Subchapter S corporation. To consider an estate, which merely succeeds to the interest of the deceased, a new shareholder seems harsh. In any event, a reaffirmation of the election and consent should be filed to avoid possible termination of the election.

71 INT. REV. CODE OF 1954, §1372(e)(3).

stock by not permitting a transfer to a trust which is often important in programming one's estate.

The fifth circumstance is if a non-resident alien becomes a shareholder.

Sixth, the election will terminate if the corporation has more than one class of stock issued and outstanding. In this regard, the increase of the debt-capitalization ratio or any subsequent recapitalization of the corporation must be carefully examined so that the government may not contend that the debt consists of a separate class of stock, and, thus, disqualify the election on the ground that more than one class of stock is issued and outstanding.[73]

Seventh, the election will terminate if the foreign income of the corporation constitutes more than 80% of its gross receipts. Note should be made that the percentage test is to be applied to gross receipts and not to net receipts or taxable income.

Eighth and finally, the election will terminate if personal holding company income, as defined in Subchapter S, constitutes more than 20% of the gross receipts of the company. It should be noted that here again reference in Subchapter S is to gross receipts rather than to net income or taxable income. The election is terminated if the gross receipts consist of more than 20% of royalties, rents, interest, dividends, annuities and gains from the sale or exchange of stock or securities. This definition of personal holding company income is different from the formal personal holding company section of the Tax Code.[74] For example, if rents constitute over 50% of the income of the corporation, they do not constitute personal holding company income under Section 346, but they will disqualify a corporation under Subchapter S. Because the reference, in speaking of foreign income and personal holding company income in Subchapter S, is to gross receipts rather than net receipts the amount must be computed without regard to returns, allowances or deductions.

A question arises under the regulations as to what constitutes rent.[75] If significant services are rendered, the receipts do not constitute rent. Thus, hotels, boarding houses, apartment houses furnishing hotel service, tourist homes, auto courts or motels generally do not produce rental income for purposes of Subchapter S. The intent of Congress seems to be to allow operating companies to obtain the benefits of Subchapter S and to withhold such benefits from mere investment type companies.

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[72] See the text at Note 9 *supra,* as to what constitutes an "affiliated group."
[73] For a discussion of thin capitalization see articles cited at note 24 *supra.*
[74] See INT. REV. CODE OF 1954, §543 for the definition of personal holding company income which may result in personal holding company status and the adverse tax consequences thereof.
[75] Treas. Reg. §1.1372-4(b)(5)(iv).

C. No Re-election for Five Years

Although a corporation or its successor may not re-elect under Subchapter S for a period of five years after termination of an election, this rule is somewhat flexible in that the Commissioner in his discretion may allow a re-election with the five-year period at any time.[76] A 50% change in stock ownership and a substantial change in corporate assets will create such circumstances so that the remaining corporation will not be termed a "successor corporation" for purposes of re-election. Thus, where such change have taken place, the regulations indicate that a re-election may be made within the five-year period.[77]

D. Date of Termination

Of particular note in dealing with an involuntary termination is that such termination applies to the current year even if it is made on the last day of such year, while a voluntary revocation applies to the following year unless made within the first month of the corporate tax year.[78] For this reason an involuntary termination invariably will be used in preference to a voluntary revocation.[79]

E. Effect of Termination

A revocation of the election under Subchapter S will cause the corporation to be subject to the normal corporate tax rates. Because of the flexibility in involuntary terminations and because such termination may be made on the last day of the corporate tax year, an involuntary termination may prove extremely valuable. Thus, the shareholders could review the financial status of the corporation near the end of its tax year and determine whether it is profitable to remain under Subchapter S or whether the election should be terminated. However, the ease and flexibility of termination may prove to be a tremendous pitfall should such termination occur involuntarily or by accident. In such case the corporation would have to pay the normal income tax for the year of termination. In addition, any distribution which had been made during the year will be taxed as a dividend to

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[76] Int. Rev. Code of 1954, §1372(f).

[77] Treas. Reg. §1.1372-5(b).

[78] Treas. Reg. §1.1372-4(c). That regulation provides in part: "Thus, if an electing small business corporation which is on a calendar year ending December 31, 1960, should issue a second class of stock on December 1, 1960, the election under Section 1372(a) would terminate as of January 1, 1960, and the termination would remain in effect for all future years unless and until a new election is made by the corporation."

[79] There are several advantages in waiting until the end of the fiscal year before deciding to terminate or continue the election under Subchapter S. First, the shareholders shall have a better understanding of the financial picture of the corporation in relation to their personal status, so that they will be able to choose the most favorable position. Second, the shareholders will have the benefit of hindsight to determine whether the election has been accidently terminated during the year. This will guide their thoughts on distributing, or not distributing, corporate profits.

the recipient thereof.[80] Thus, in effect, there will be a double tax on income earned.

F. Substance Rather Than Form

A question arises as to whether the Commissioner will look to substance rather than form in cases of involuntary termination. For example, where one shareholder transfers one share of stock, in trust, for his son and thus terminates the election on the last day of the corporate tax year, will the Commissioner take the position that such transfer was a mere sham and that there was no reason other than tax avoidance for the transfer? It is doubted whether the courts will require a non-tax reason for "involuntary" terminations in view of the fact that Subchapter S is so specific in reciting the instances in which termination will be effected.[81]

G. Protective Measures

Perhaps the greatest deterrent in electing under Subchapter S is the possibility of accidental or involuntary termination of the election and a subsequent incurrence of double taxation. Such involuntary termination can occur by accident where share are transferred to more than ten shareholders, where shares are transferred to a trust or where a new shareholder fails to consent to the election within 30 days after becoming a shareholder. In addition, a minority or disgruntled shareholder may threaten to transfer one share in trust and thus terminate the election if corporate decisions are not made in accordance with his wishes. In other words, a shareholder may use the ease of terminating the election and the possible disastrous tax consequences as financial blackmail to force the remaining shareholders into whatever course of action he may desire. For these reasons, certain protective measures must be taken in every instance in which a corporation elects under Subchapter S.

In order to avoid accidental termination or the possibility of the threat of termination and financial blackmail, there should be an agreement restricting the sale of stock by a shareholder during lifetime, with perhaps a first right of refusal or first option to purchase in the remaining shareholders or in the corporation, together with a buy-out arrangement upon the death of a shareholder. Because a purchaser may take in good faith and title may pass (which would amount to a termination if such transfer would increase the shareholders to more than ten), care should be taken to have the restriction printed on the face of the certificates or to have the certificates deposited with an escrow

[80] The normal rules governing the taxation of corporate distributions would apply so that dividends would be measured by the earnings and profits of the corporation.

[81] Compare Treas. Reg. §1.1373-1(a)(2) with its emphasis of substance over form with Treas. Reg. §§1.1372-4(6)(1) and 1.1372-5 which appear to emphasize form.

holder. Perhaps the articles or charter and by-laws of the corporation themselves should contain restrictions concerning the transfer of shares.[82] In addition to the buy-out agreement and the restrictions on sale contained therein, the shareholder's Will should contain specific instructions as to the election. Because an estate must elect within 30 days after the qualification of the executor or administrator (assuming the estate is considered a new shareholder),[83] the will should direct the executor either to elect or not to elect under Subchapter S. Such instructions will serve not only as notice to the executor or administrator but will enable him to act with dispatch within the time prescribed by the regulations. If no such direction is given, the executor must look only to the preservation of estate assets and in doing so he may decide not to elect and thus adversely effect the entire corporate scheme.

In the event there is no buy-out agreement in effect the method of distribution as provided under the will should not distribute the stock to such number of persons as will increase the number of shareholders to more than ten because, in such event, the election will automatically be terminated.

In addition, the stock may not be placed in or distributed to a trust under the will because a trust does not qualify as a shareholder and, in such event, the election will also be terminated.

H. Statue of Limitation

Concerning the statute of limitations, Section 6037 provides that the three-year statue will begin to run from the date following the filing of Form 1120-S (the income tax information return required to be filed by a Subchapter S corporation) or the date prescribed for filing such form if it occurs later.[84]

I. Remedial Proposals

In the event a corporation is disqualified under Subchapter S by accident or through involuntary termination, it has been suggested that legislation be enacted allowing a shareholder to contribute to the capital of the corporation and obtain a deduction therefor.[85] The reasoning behind this proposal is that disqualification by accident or involuntary termination may happen so easily and the result would be so disastrous as to be inequitable to the shareholders. A similar suggestion

82 A problem arises as to how to restrict th transfer of shares in the event a shareholder dies and his shares are divided among more than ten (10) heirs. The heirs were not parties to the original restrictive agreement and may not be bound thereby. Thus, the agreement should specifically state that all assignees and heirs of the parties are bound. In addition, the restriction could be placed directly in the charter of the corporation.

83 See the discussion at note 70 *supra*.

84 There appears to be no reason for not applying the normal Statutes of Limitations to a Subchapter S corporation.

85 Patty, *Qualification and Disqualification Under Subchapter S*, N.Y.U. 18th Inst. on Fed. Tax 661 (1960).

is contained in the 1959 report of the section of taxation of the American Bar Association.[86]

When to Elect—Summary of Advantages and Disadvantages of Subchapter S

The problem of when a corporation should elect under Subchapter S is one that is based upon business considerations, both tax and non-tax, the possible beneficial use of fringe benefits and other advantages of the corporate form, and the many technicalities governing the election under Subchapter S.

A. Advantages for the Partnership and Sole Proprietorship

1. *Exemption from Personal Liability*

Perhaps the greatest non-tax advantage and benefit conferred upon a sole proprietorship or a partnership which elects under Subchapter S is that the shareholders are exempt from personal liability regarding the acts of the corporate business.[87]

2. *Continuity of Interests and Centralization of Management*

The corporate form offers a continuity of interests which is not present when operating as a sole proprietorship or as a partnership and a centralization of management which is not present when operating as a partnership. In addition, equality of managerial control may be obtained under Subchapter S despite the fact that the pecuniary interests of the parties may be unequal, because under Subchapter S different classes of stock may elect their own directors. Assume, for example, that the Articles of a corporation provide for five (5) directors. Two-fifths of the stock could be issued to one shareholder and three-fifths of the stock could be issued to the other shareholder. The Articles could then state that action could only be taken by four-fifths of the directors, or by four (4) directors acting in concurrence. If there were five directors, the first shareholder could be given the right to elect two directors and the second shareholder could be given the right to elect three directors.[88] For convenience, they could be termed "Class A directors" and "Class B directors." Then, in effect, no action could be taken without concurrence of both shareholders even though one

[86] 1959 Report of the Section of Taxation of the American Bar Association 92-3.

[87] Although lending institutions may require the personal guarantees of the major stockholders, the corporate form of operation still offers protection from personal liability particularly in the fields of contracts and torts.

[88] One writer has interpreted the proposed regulations as requiring an equal number of outstanding shares of each class of stock in cases where each class may elect its own directors. See: Murdoch, *Effect of Subchapter S on Decisions as to Form of Business Organizations*, Jan. TAXES 19, 21 (1960). The final regulations, Treas. Reg. §1.1371-1(g) state:

> However, if two or more groups of shares are identical in every respect except that each group has the right to elect members of the board of directors in a number proportionate to the number of shares in each group, they are considered one class of stock.

Thus, it would appear that there is no necessity of having an equal number of shares of each group outstanding.

has a right to a greater amount of profits. In order to accomplish such a result, similar restrictions should also be placed upon the voting of stock.

3. *Availability of Fringe Benefits*

.The adoption of the corporate entity opens the door to a variety of so-called fringe bentfits such as deferred deductible group insurance, accident and health insurance, exempt sick pay plans, plans for up to $5,000 tax-free payments on death or retirement, profit sharing plans, pension plans, stock bonus plans, stock option plans and others.

4. *Timing of Income*

Subchapter S allows for a certain control and timing of taxable income. By choosing an appropriate fiscal year the shareholders may initially defer the receipt of income for one year.[89] In subsequent years the shareholders may control the amount of income in each particular year by either declaring dividends and reporting the dividend income on their own tax return for a given year, or by postponing the declaration of dividends until the subsequent calendar year and reporting the taxable income in such following year.

5. *Gifts and Transfers*

Under Subchapter S income may easily be shifted among family members by simply transferring ownership of stock. Because of the peculiar rules of Subchapter S in that net losses are allocated according to the number of days the stock was owned,[90] and net gains are allocated in proportion to stock ownership as of the last day of the corporate tax year, appropriate gifts near the end of the tax year may achieve favorable income shifting results. Subchapter S is also advantageous in that it adds to the maximum limitation which an indivdual may take as a charitable deduction.[91]

B. ADVANTAGES FOR EXISTING CORPORATIONS

1. *Corporate Tax Brackets and the Elimination of the Corporate Tax*

Turning to the tax advantages afforded by Subchapter S, the primary benefit lies in the elimination of the corporate tax.[92] In addition,

[89] Assume, for example, that the shareholders are on a calendar year and they select a January 31 fiscal year for the corporation. Assume further that the corporation is established January 31, 1960. During the year 1960 no dividends are declared by the corporation so that at the end of 1960 the shareholders have little, if any, income to report from the operation of the corporation. Then, on January 31, 1961, which is the end of the corporate tax year, any earned income undistributed by the corporation is taxed to the shareholders as of that date. In other words, instead of reporting the corporate income during 1960 when it was actually earned, the shareholders will report it on their 1961 tax return, because it was constructively received on January 31, 1961, as a dividend.

[90] INT. REV. CODE OF 1954, §1374(c)(1).

[91] In addition to the limits allowable to the individual, the corporation may contribute 5% of its taxable income to charity and by so doing reduce taxable income of the corporation. This, in turn, will reduce the income reportable by the shareholders. See INT. REV. CODE OF 1954, §170(a).

[92] However, it should be noted that under Subchapter S the dividends re-

the election may prove beneficial where the individual tax rates are lower than the corporate tax rates.

2. *Unreasonable Accumulation of Income*

Subchapter S provides a further tax advantage in that there is no possibility of incurring the penalty for an unreasonable accumulation of income due to a retention of Subchapter S income.[93] This preventive aspect of Subchapter S does not apply to surplus accumulated prior to the Subchapter S election.

3. *Problem of Excessive Salaries*

An election under Subchapter S should eliminate most problems relating to excessive salary payments. Family employees who are also majority stockholders sometimes draw high salaries from their closely held corporation in an attempt to draw money out of the company and create a deduction for the company. This procedure become unnecessary under Subchapter S because a majority of corporate profits will be taxed to the majority stockholder and may be withdrawn each year on a tax free basis. It should be noted that Subchapter S may be utilized to divide corporate profits among family members by dividing the ownership of stock.[94]

4. *Partial or Complete Liquidation*

If a corporation undertook a partial liquidation and could not qualify for the benefits of section 346 relating to partial liquidations, it may be wise to elect to be taxed under Subchapter S. Thus, the corporation could sell a substantial part of its assets and distribute the proceeds. The excess of net long-term capital gain over any short-term capital loss is reportable by the individual shareholders as long-term capital gain. However, in order to gain any tax advantage, such gains must be substantial in comparison with the corporate losses, because the shareholders may only report the net gain. Thus, the ordinary corporate losses which would otherwise pass to the shareholders will be used to offset capital gains. If the election had been made, (and if the capital gains substantially exceed the ordinary losses), there would be one capital gain to the shareholders. If the election had not been made, there would first be a capital gain to the corporation and a subsequent dividend to the individual on the distribution.

5. *Net Operating Loss and Section 337*

Another instance where Subchapter S may be used is in the case of a distribution of an operating loss, expecially if a sale is made

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ceived credit, retirement income credits, and the $50 dividend exclusion are not available. INT. REV. CODE OF 1954, §1375(b).

[93] See INT. REV. CODE OF 1954, §§531-37 for the rules and penalties governing unreasonable accumulations of income.

[94] The regulations indicate that the government will attribute a reasonable salary to the family member or members who are actually employed by the company, and only the excess will be divided among the other family shareholders. Treas. Reg. §1.1373-1(a)(2).

pursuant to section 337. Section 337 enables a corporation to elect to dissolve, then to sell assets and avoid a corporate tax on the sale with the result that there would be only one capital gain on dissolution of the company. Thus, if a company had an operating loss and elected under Subchapter S, that operating loss could be taken as an ordinary loss by the shareholders. If the corporation wished to sell a major portion of its assets during the same year, any capital gain recognized on the sale would have to be set off against the ordinary loss before the loss could be taken into account by the shareholders. This would not be feasible taxwise from the shareholders' standpoint. Therefore, under these circumstances the corporation should elect under Section 337 so that no gain will be recognized on the sale. As a result, the shareholders will be able to take the full operating loss on their individual returns, and on the subsequent dissolution of the company will report any gain at that time as a capital gain.[95]

The use of Subchapter S will probably have to meet the test of whether the entire transaction is a sham and merely a tax avoidance device, and whether in fact there is any business purpose involved.[96] Generally, extreme caution should be exercised before adopting Subchapter S in order to obtain a "one-shot" tax advantage.[97]

C. Advantages for New Corporations

1. *Anticipation of High Loss Years*

Because the net operating loss of a Subchapter S corporation may be taken proportionately by the shareholders, themselves, the election should be made when business losses are anticipated. This may be particularly true of a new business, because high depreciation rates, costs of establishing an inventory and the often slow increase in customers often produce losses for the first few years. Under Subchapter S capital gains are used to offset ordinary losses. Therefore, if losses are expected, care should be taken that no unnecessary capital

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[95] It should be noted that the proposed regulations contained a statement to the effect that Subchapter S cannot be used if a partial or complete liquidation is in process. This statement was eliminated from the final regulations, and it is assumed that Subchapter S does apply to corporations in the process of partial or complete liquidation.

[96] For a discussion relating to the necessity for a business purpose see: Roemele, *To Qualify for Subchapter S must Reorganizations have Business Purpose,* 13 J. Taxation 102 (1960).

[97] Subchapter S may also be used to attempt to circumvent the collapsible corporation rules found at Int. Rev. Code of 1954, §341. For example, a corporation could be established to build an apartment building. Six months after the building has been completed, but before substantial rental income has been received, the shareholders wish to sell the building and receive their gains. Under Int. Rev. Code of 1954, §341, they must normally wait three years before dissolving the corporation if they are to receive favorable tax treatment. If they were to elect under Subchapter S, the corporation could sell the building and distribute the capital gain. There would be one capital gain tax on the sale, such tax being payable by the shareholders. But see, Treas. Reg. §1.1375-1(d).

gains are incurred for the year in question, but such gains should be taken in a profitable year when they may be reported as capital gains by the shareholders.

D. Possible Disadvantages of Subchapter S

1. *Involuntary or Accidental Termination*

Perhaps the greatest disadvantage in electing under Subchapter S lies in the possibility that the election be involuntarily or accidentally terminated with the disastrous result of a tax on both the corporate level and the shareholder level.

2. *Right to Withdraw Previously Taxed Income is Personal to the Taxpayer*

A second detriment to the election under Subchapter S is that a stockholder who has already paid tax on his pro rata share of corporate earnings cannot transfer a right to a non-taxable distribution of that income to any other person. It is personal to the particular shareholder.[98]

3. *Necessity of Late Returns*

A further tax detriment arises under Subchapter S if the corporation is on a fiscal year and has substantial capital gains during the year. Because the amount of capital gains cannot be determined until the end of the fiscal year, the individual may not know his reportable share of capital gains until the due date for filing his own personal return has long passed. Thus, he may have to file supplementary returns or file for refund for an estimated tax which he paid previously.

4. *Loss of Prior Loss Carryover*

The loss carryover in a corporation previous to its election under Subchapter S is not available once the election has been made. However, if upon termination of the election, such loss carryover is still available (counting the years under which the corporation operated as a Subchapter S corporation), then that loss carryover may be used in the years following the termination of the Subchapter S election.

5. *Avoidance of Property Distributions*

Property distributions are to be avoided by a Subchapter S corporation because they do not serve to reduce the undistributed taxable income. Thus, if property distributions are made the shareholders may have to report income in excess of the current taxable income of the corporation if the corporation has sufficient accumulated earnings and profits.

6. *Capital Losses*

Capital losses are not carried over to the individuals. Presumably the capital loss carryover is available to the corporation in computing its taxable income the following years.

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[98] Treas. Reg. §1.1375-4(e).

7 State Income Tax Laws

Because state income tax laws may still treat the corporation as a taxpayer, confusion may arise between the interplay of federal and state income taxes on the corporate and individual levels. Such confusion should be corrected by proper administrative rulings dealing with the problems involved. Under Wisconsin law, for example, the corporation electing under Subchapter S will lose a deduction on the state corporate tax return because no corporate income taxes will have been paid.[99]

CONCLUSION

Subchapter S has engendered a great amount of interest since its enactment. It represents an attempt by Congress to aid private small businesses. Although the many technicalities inherent in Subchapter S may be detrimental to its effective operation and may require legislative changes, the advantages of Subchapter S should outweigh the disadvantages and prove beneficial to many businessmen.

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[99] WIS. STAT. §71.04(3)(a) (1959).